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Hazards of basing an estate plan on successive life estates

by Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University, Ames, Iowa. Member of the Iowa Bar, 515-294-6354, harl@iastate.edu

Recent reviews of two fact situations, hundreds of miles apart and both the products of planning a half century or more ago, illustrate the hazards of using a deceptively simple estate plan – basing the plan on successive life estates. The strategy often involves unexpected federal estate tax consequences, federal gift tax problems, income tax basis complications and assorted problems relating to like-kind exchanges, involuntary conversions and easements, to mention just a few of the more likely events occurring during the term of the life estates. Although often viewed as more complex (and costly to set up), a carefully drafted trust generally provides a more satisfactory platform for intergenerational transfers than successive life estates.

What is the income tax basis?

Other than for tax audits and title problems, the most likely occasion for examining a trail of life estates spanning several decades is the question of income tax basis. The individual or individuals ultimately acquiring a fee simple ownership of the property decides to sell the property or dispose of it in a taxable exchange and wants to know what the income tax basis is currently. This often occurs several years after the last determination of income tax basis for the property.

Retained life estate or life estates. One common feature of plans involving successive life estates is that the original owners often retained a life estate for themselves with a life estate granted to one or more children (and perhaps their spouses) to follow their retained life estate or life estates followed in turn by a fee simple interest to grandchildren. If that is the pattern, the retained life estate or estates assured that the property in question would be included in the gross estate or gross estates of the holder or holders of the retained life estate (the original grantors). That may trigger federal estate tax liability, of course. Even if it does not result in federal estate tax liability, the inclusion in the federal estate tax gross estate determines the income tax basis for the property for purposes of depreciation, depletion or amortization as well as for purposes of gain or loss

on sale or taxable exchange. In the event the property is owned in joint tenancy, additional complications arise. If the property was acquired by the donors after 1954 and before 1977, the rule of *Gallenstein v. Commissioner* may possibly apply which allows the so-called “consideration furnished” rule to be used to determine the amount to be included in the gross estate at the first of the joint tenants to die and to determine the income tax basis. Five more cases have been decided, in addition to *Gallenstein*, all in favor of the taxpayer. Thus, if it is a husband and wife joint tenancy, the property was acquired in 1975 with the husband providing the consideration and the husband died in 1981, for example, the entire value of the property would be included in the gross estate and receive a new income tax basis. On the other hand, if the wife provided all of the consideration, none of the value would be included in the gross estate and the income tax basis would be unaffected by the husband’s death. The Tax Court has held that the *Gallenstein* rule is mandatory, not optional and IRS has acquiesced in that decision. However, for the *Gallenstein* rule to apply, the joint tenancy feature must have continued to the death of the first to die and there is a question whether the rule applies to a conveyance of joint tenancy property with a retained life estate which may depend upon whether the joint tenancy feature was severed at the time of the conveyance.

A further question is whether the basis, if the *Gallenstein* rule does not apply, is derived equally from the two deaths or whether the income tax basis would pass from the second death if the retained life estate is deemed to be in joint tenancy (either by express language or otherwise). In *Glaser, Jr. v. United States*, a transfer with retained life estates of property held in tenancy by the entirety (similar to joint tenancy) for which the decedent furnished the entire consideration and which, therefore, the entire value if held until death would have been includible in the gross estate, only a one-half interest was required to be included in the decedent’s gross estate. In *United States v. Heasty*, the Tenth Circuit Court of Appeals reached the same con-

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clusion with joint tenancy property. The Seventh Circuit in *Glaser* and the Tenth Circuit in *Heasty* agreed that I.R.C. § 2040 on taxation of joint tenancy property *applies only to property held at death*.

Effect of successive life estates on the basis. As for the successive life estates, following the termination of the retained life estates, the deaths of those holders of the granted life estate would not affect the income tax basis of the property. Granted life estates are not included in the gross estate of the holder or holders and, therefore, do not affect the basis. Of course, this assumes no depreciable property which would add another complication.

Federal gift tax concerns

If successive life estates are set up during the lifetime of the original owner or owners, the life estates following the retained life estates would almost certainly have encountered federal gift tax requirements for gifts of future interests. A gift of a life estate interest in property to commence at a future time would be considered a future interest. Therefore, the federal gift tax annual exclusion would not have been available to cover or to help to cover the transfer.

The rule against perpetuities

In those states that have not repealed the Rule Against Perpetuities, successive life estates can violate the rule just as surely as would life estates in trust. Indeed, the original litigation, *The Duke of Norfolk's Case*, involved successive life estates. This issue, for situations dating back several decades, is most likely to be raised, if at all, in connection with a title examination (or by unhappy heirs). Basically, the Rule provides that no interest in real estate is good unless it must vest, if at all, not later than 21 years after some specified life or lives in being at the creation of the interest. A slightly different rule applies in states that have adopted the Uniform Statutory Rule Against Perpetuities (USRAP).

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Improvements to ag decision maker

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Changes to the Ag Decision Maker (AgDM) website and publications have recently been made to better meet the needs of our users. The print version of AgDM will remain the same, but website updates of Information Files and Decision Tools will switch to a bi-monthly format.

The Ag Decision Maker newsletter with Information File and Decision Tool updates will now be posted the middle of each month. The first week of each month another update will be done to include more Ag Decision Maker updates, as well as the Iowa Farm Outlook newsletter and the Ag Marketing Resource Center's Renewable Energy newsletter. Notification of these

updates is free and sign-up is available by e-mailing agdm@iastate.edu or through the Notification web page at: <http://www.extension.iastate.edu/agdm/notify.html>.

A blog has also been created to answer frequently asked questions from clients. The blog will be updated several times a week with answers, upcoming events, and other resources on Iowa farm management and outlook for making well informed ag decisions. The address for viewing the blog is: <http://blogs.extension.iastate.edu/agdm/>.